Free Markets and Competitive Norms
Decoupling from Commodity Programs

INTRODUCTION

Since the 1920's, economists, policymakers and farmers have debated the need
for programs to deal with surplus conditions in agricultural markets which
drive farm prices below variable costs of production. For the most part,
economists argued for reliance on the free market and the competitive
system to cure the problems of low prices and low income brought about by
excess supplies. Some economists, however, suggested that unrestricted
competition results in distructive actions and suggested that government
intervention could improve market performance (4). Farmers and many of their
organizations asserted that they were at a disadvantage in the market compared
with other industries and needed help to get a fair deal. Policymakers
listened to both their farmer constituents and to economists. More often than
not they agreed with the view that agricultural markets were depressed and
sold this view to consumers and taxpayers. Family farmers were identified as
the backbone of our society. Policymakers pointed to depressed farm incomes
and suggested that aid to commodity producers was necessary to protect our
food supply.

Intervention programs were designed to raise total income for the sector and
average incomes of commercial producers of program commodities above free
market levels (2). The programs, by supporting prices, holding stocks, idling
land and providing direct payments transfer income from taxpayers and
consumers to farmers. As the various administrations have operated the
programs since the 1930's, they have provided annual price floors for program
commodities. During most the past 55 years, these floors exceeded short run
market clearing levels. Over the entire 55 year period, they have exceeded

long run free market prices. Thus, the price floors have encouraged production which was larger than the market could clear. The excess over sales accumulated in government storage programs and this led to restrictions on production to avoid further accumulations. For the producers of program commodities, income and asset values were higher than they would have been in the absence of the programs.(2) The majority of producers of program commodities became dependent on or coupled to the income support programs.

A change in direction occurred with The Food Security Act of 1985 (FSA) which moved a step away from price supports and a step toward market orientation by allowing price floors and commodity prices to decline. Under the 1985 Act income support to producers of program commodities has been maintained through direct payments base on program yield and program acreage. To facilitate the transition to market orientation and provide protection to producers against the shock of a rapid price decline, direct income support was increased. Substantial expansion in government cost occurred because the direct payments replaced hidden transfers from consumers through supported prices.

In the 1980's the size and distribution of the program budget have become major policy issues. The purpose of the income transfer and effectiveness of the program in achieving income stability appear to be in question and there is considerable debate over whether these income transfers should continue. Some question whether certain commodity producers still deserve a larger than free market share of income. If they do not, there may be a need to cushion the transition to a free market as they are decoupled from the subsidy. While many oppose income support they suggest that the government may have a role in providing for market stability.

The objectives of this paper are to (1) consider how a free agricultural

market would differ from the normative competitive market and (2) to suggest how Federal programs might be used to improve discovery of long run prices and thus improve resource allocation in a market oriented system with minamal Government intervention.
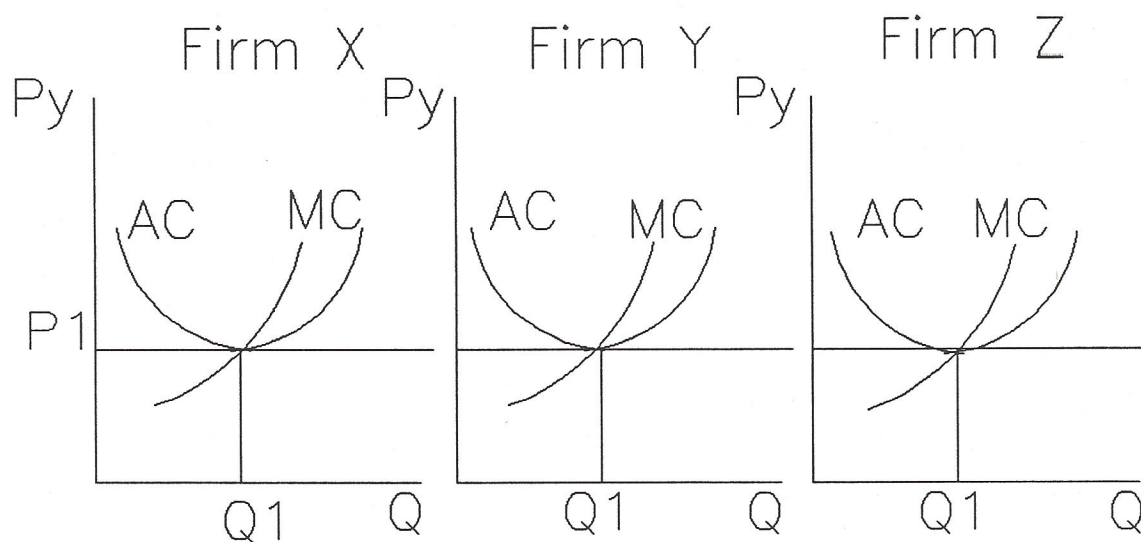
THE COMPETITIVE MARKET NORM

At the center of the agricultural policy issues is the basic premise that the compeitive market is an efficient and equitable allocator of resources and that the free market for agriculture resembles the competive norm sufficiently to infer that it would produce an efficient and equitable solution to price and resource adjustment.

The assumptions of competitive market theory are a scale against which we measure economic performance. According to these assumptions, market intervention should occur only in cases where the market failed to behave competitivly. If markets are effective, efficient and equitable, they will result in just the right use of resources to produce just the right quantity of a commodity and free trade will result in countries producing according to their comparative advantage. An equilibrium is achieved between production and consumption. This competitive theoretical framework assumes perfect knowledge and instantaneous adjustment to equilibrium for long run and short run positions. That is, there is no short run. Resources adjust (enter or exit the production process) and excess resources are eliminated. No stocks are carried in the system because production is in equilibrium with consumption and instantaneous adjustment occurs after a shock.
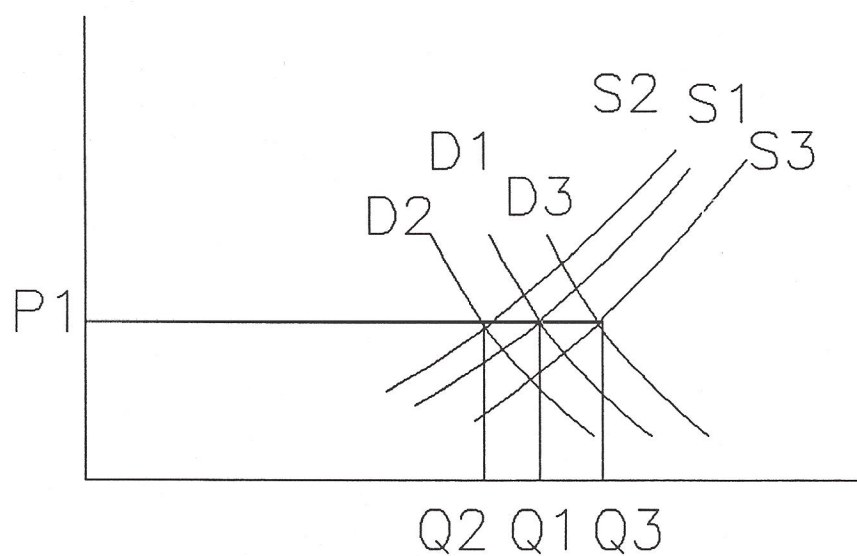
Figure 1 depicts three firms in a normative competitive structure. All produce at the same cost and receive the same price. The firms are so small

Figure 1
Competitive Norm Equilibrium

Firm X

Py

AC   MC

P1

Q1   Q

Firm Y

Py

AC   MC

P1

Q1   Q

Firm Z

Py

AC   MC

P1

Q1   Q

Commodity Sector

P1

D1
D2   D3
S2 S1
S3

Q2 Q1 Q3

that they do not affect the market price by their decision to produce. Resourse supplies are readily available at current prices. Entry and exit are costless and shocks induced by a change in sector demand are adjusted to by entry or exit of firms. The commodity sector panel of figure 1 depicts the effects of a demand decrease to D2 and an increase to D3. A new equilibrium is achieved instantaneously. The market passes information from consumers to producers concerning the quantity of resources to use in production and how much to produce. In a free competitive market, quantity and price adjust to bring about an equilibrium between the quantity producers are willing to supply and the quantity comsumers are willing to buy.

THE FREE MARKET DEPARTS FROM FROM THE NORM

The model just presented is a useful guide for analysis, but the market for farm commodities departs from the assumptions of the perfect market model in several important ways. Specifically, participants lack perfect knowledge; production and consumption do not adjust simultaneously; random shocks from weather affect production and there is not a fixed functional relationship between units of input and units of output; and production is seasonal, but consumption is continuous. In addition, farms vary in size, technology, resource quality, and products produced. And, although producers can plan for an expected output and estimate how that output might vary, they have no basis for determining how output will vary in any one year.

In the free market the quantity shocks that occur because of weather induced yield variability are more than trivial conditions. Although producers can calculate the likelihood of a particular shock, they have no information at planting time on the magnitude of the shock that will occur this year. Even if no economic varibles change, weather will bring about a mismatch between expected and actual yield and therefore expected and actual prices. Because

5

the market allocates actual production among consumers rather than allocating expected supply among expected demands. And, because production is seasonal while consumption is more or less continuous, fundamental economic shifts in demand or supply, as opposed to wheather induced supply shifts, are difficult to identify. Thus, producers, consumers and policy-makers have difficulty in forming expectations that conform to the basic economic forces in the market and in adjusting toward an equilibrium position.

Free market planting decisions must be made using an expected price and an expected cost relationships. Investments are lumpy and capital can not be discretely altered once an investment is made. Production takes place if returns are expected to be sufficient to cover variable cost. However, it is only coincidental if expected cost and actual cost or expected price and actual price equate. If the expectation are realized producers earn a return sufficient to cover variable cost and some or all of the fixed cost. If expost returns are insufficient to cover ex ante costs, losses are incurred and firms go into debt, use previous savings or sell of their assets to a more successful producer.

The first two panels of Figure 2 represents two firms out, of many, in a free market and show their expost condition relative to market price for the commodity and costs. Firm A lost money while firm B made a profit. As a result firm A goes out of business and firm B acquires the assets forming firm AB shown in the third panel. Because of the reorganization, firm AB is able to produce the combined output of A and B at a lower cost than either A or B and can earn a larger profit at the prevailing prices prices for the commodity by expanding output beyond the previous level to Qab'. With other firms expanding production through similar reorganizations or because of technologiacal change